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ABSTRACT

One of a series of units on business issues designed for secondary school students, this packet examines white collar crime. Teacher and student materials are provided in two separate sections. The teacher's guide contains four lesson plans as well as research project recommendations, student handouts, answer keys, and suggestions for using a business person as classroom resource. The student materials section presents readings on the insurance business, government regulatory agencies, and corporation management. Also included is a case study of insurance company fraud. Presented as a skit, this case illustrates the responsibilities of the Board of Directors and corporate management to stockholders and customers, the responsibilities of government watchdog agencies, and the responsibilities of accountants in their audits of a corporation's financial records. Follow-up discussion and a vocabulary review sheet complete the unit. (LP)

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# WHITE COLLAR CRIME

Instructor's Guide

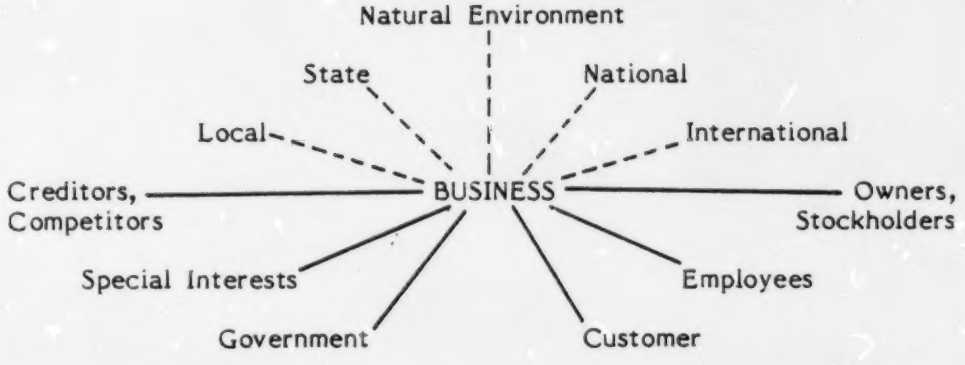
SO 015 374

Author: Phyllis F. Maxey
Business Issues in the Classroom
Constitutional Rights Foundation
Los Angeles, California
Revised, 1983

## WHITE COLLAR CRIME

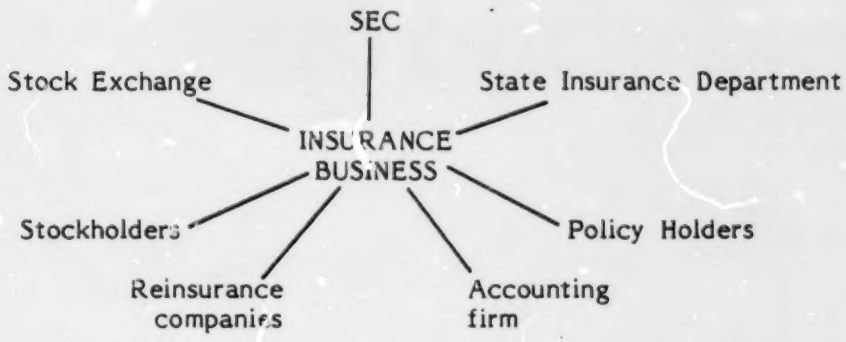
OVERVIEW

Business Issues in the Classroom (BIC) introduces students to exciting, difficult, and complex decisions that face the business community today. Case studies and activities help students understand the setting in which American companies must function. This business environment includes many groups with conflicting interests: stockholders, consumers, employees, special interest groups, business competitors and creditors, and government. These groups affect business and, in turn, are affected by business decisions. Each BIC lesson plan focuses on a specific issue which highlights a particular relationship in the business decision-making environment.




THE BUSINESS DECISION-MAKING ENVIRONMENT

In this unit, students have the opportunity to unravel a white collar crime. To prepare them for this complex case, they will first learn about the insurance business and the management structure of corporations. Insurance fraud is the subject of the case study — a fictionalized, simplified account of the actual Equity Funding Corporation case. This case illustrates the responsibilities of the Board of Directors and corporate management to stockholders and customers, the responsibilities of government watchdog agencies such as the Securities and Exchange Commission (SEC), and the responsibilities of accountants in their audits of the corporation's financial records.




THE INSURANCE BUSINESS ENVIRONMENT

Activities include two readings, one focusing on the insurance business and the other on the structure of a corporation. The case study is presented as a dialogue in which students can take the roles of people in the All Star Insurance Company. Discussion questions follow the case, and a Vocabulary Worksheet helps students review the new terms introduced in this unit. This guide provides the instructor with background material on the actual Equity Funding case and the consequences for those executives involved in the fraud.

OBJECTIVES

Students will be able to:

1. explain why people buy insurance and how the insurance business works.
2. describe a corporate business organization and the various levels in the corporate hierarchy.
3. explain their views about unethical business practices and individual responsibilities in a white collar crime case.

TIME FRAME

4 or more class periods

## CLASSROOM APPLICATIONS

Day 1 Reading and Quiz: Assign the readings, "Insurance Fact Sheet" and "What is a Corporation?," p. 2-6, for homework or in-class reading. You may wish to use the Vocabulary Worksheet, p. 15, to assess students' understanding of terms introduced in the readings. It is important that they understand this terminology since it is used in the case study.

Day 2 Concept Building and Discussion: Carefully review the idea of insurance and such terms as premium, policy holder, reserve requirements, reinsurance, auditor, and fraud. If students do not grasp the concept of insurance, you might invite a business resource person to join your class or use additional curriculum materials to aid students' understanding.

Refer students to the chart on corporate structure on p. 5, and check their understanding of the corporate type of business organization and its management. Review such terms as stockholder, director, investment, executive, and limited liability.

Day 3 Dialogue and Discussion: Assign five students to the roles in the dialogue. Tell students to focus on Mr./Ms. Thomas. After the reading, you will be discussing what he/she should do.

Mr./Ms. Solo, President of All Star Insurance
Mr./Ms. Greenstein, Vice President
Mr./Ms. Crawford, Junior Executive
Mr./Ms. Hunkins, Computer Analyst
Mr./Ms. Thomas, Member of the Board of Directors, Chairman of the Audit Committee

Read the dialogue, p. 12, aloud.

Using the discussion questions on p. 13, discuss the All Star case with the students. Try to avoid talking about the real Equity Funding case until after the discussion of the All Star case.

After discussing the All Star case, have students write an essay stating their own decision and rationale in answering the question, "What should Thomas do?"

Day 4 Lecture/Discussion: Present the Equity Funding case described on p. 6-12 of this Instructor's Guide. This is an excellent time to ask an auditor, insurance specialist, or a lawyer to class to discuss the Equity case and the problem of white collar crime.

Follow-up Activities: Research Project. Discuss with the students the list of topics found on p. 15:

Securities and Exchange Commission
State Department of Insurance
Stock exchanges
Insurance business, reinsurance
Audits, accounting practices
Computer-assisted crimes
Fraud
Corporations — structure and responsibility of Boards of Directors, management, employees
Business ethics — codes of ethics, responsibilities of accountants, insurance companies, etc.
Investment — the role of stockbrokers, securities analysts, investment counselors
Famous cases of white collar crime

Students may want to work in teams. Review procedures for using the library and for researching a topic.

You can also extend this lesson by using other BIC materials which emphasize corporate responsibilities to stockholders (owners) and customers, as well as the role of government agencies. See the BIC curriculum materials for reference.

## USING A RESOURCE PERSON IN THE CLASSROOM

The Business Issues in the Classroom Program (BIC) has a talented group of business professionals who are prepared to teach one day of this unit. At least two weeks in advance, call the Constitutional Rights Foundation (213) 473-5091 and ask the placement coordinator to arrange a visit.

The business resource person could participate in the following way:

Day 1: present background information on the insurance business
Day 3: lead a discussion of the All Star case
Day 4: present the Equity Funding case
Day 5: discuss actions being taken to stop white collar crime

Answers to Vocabulary Worksheet, p. 15

| | | |
|---|---|---|
| 1. fraud | 2. policy holder | 3. stock exchange |
| 4. beneficiary | 5. white collar crime | 6. securities |
| 7. reinsurance | 8. premium | 9. auditor |

The chart should resemble the one presented on p. 5 of the student materials.

## THE EQUITY FUNDING CASE

One of the most massive and successful white collar frauds ever uncovered in this country was created by the Equity Funding Corporation of America during the 1960s and early 1970s. The corporation held many subsidiaries, of which Equity Funding Life Insurance Company was one. Equity not only created fictitious insurance policies, but it also listed fictitious assets, loans, securities transactions, and inflated assets.

In the late 1960s, Equity began falsifying records to improve its reported income and assets. Equity Life Insurance Company personnel created fictitious life insurance policies and sold them to reinsurance companies. The fake policies created a sense of growth that prompted investors to buy the company's stock, forcing stock prices up. Shares that has once sold at $12 rose ultimately in price to $80.* According to Raymond Dirks in his book, The Great Wall Street Scandal, Equity planned eventually to purchase a healthy insurance company, thus using the phony policies as a "loan" to be repaid.

The phony policies were no small fraction of the business, but an increasingly major portion of it. In its 1979 annual report, Equity listed $2.2 billion in active life insurance policies; $1.3 billion was fictitious. A year later, Equity's listing of $3.7 billion in life insurance policies had been artificially inflated by $2.1 billion in fictitious policies.** Ultimately, the company created about 56,000 phony insurance policies, along with forged bonds and death certificates, listing $120 million in fictitious assets.***

In March of 1973, Ronald Secrist, a recently fired Equity official, told Raymond Dirks, a Wall Street securities analyst, of the fraud. Dirks began an investigation that led to the company's collapse a month later. His information prompted the Securities and Exchange Commission to embark on a seven-month

*Dirks, Raymond and Leonard Gross, The Great Wall Street Scandal, McGraw-Hill, New York: 1974.

**American Institute of Certified Public Accountants, "Report of the Special Committee on Equity Funding": 1975, p. 21.

***Sobel, Lester A., ed., Corruption in Business, Facts on File, Inc., New York: 1977, p. 172-174.

investigation. During that time, state insurance departments in Illinois and California sprang surprise audits on the company. The Illinois department discovered $25 million in bonds, claimed by Equity to be in the American National Bank and Trust in Chicago, to be non-existent. At the same time, the California department found 56,000 fake insurance policies and 35,000 genuine ones.*

The New York Stock Exchange halted Equity's trading late in March, and charged Dirks with spreading rumors and giving his clients inside information which they then used in trading Equity's stock.

The U. S. District Court in Los Angeles ordered Equity Funding Corporation to file for bankruptcy April 4, 1973. A federal grand jury in Los Angeles handed down a 105-count indictment against 2 people on November 1, 1973. Stanley Goldblum, co-founder, chairman, and president of Equity Funding Corporation, was charged with forging policies, computer records, death claims, files, bank documents, securities purchase confirmations, and bonds, and preparing false financial records and re-selling fictitious policies. He was sentenced March 18, 1975 to eight years in prison and ordered to pay $20,000 in fines. Fred Levin, president of the insurance subsidiary and once executive vice president of the corporation, was sentenced to five years in prison. Both men were also sentenced in the state of Illinois, Levin for two to eight years and Goldblum for three to ten years, for forging a letter which made it seem the corporation held $24 million in corporate bonds in that state. Other Equity officials were sentenced to serve jail terms of six months to five years, with fines up to $5,000.

Three accountants who had worked within the firm were charged with intentionally conducting incomplete audits of Equity. They were each sentenced to three months in prison.

*Sobel, Ibid.

Stockholders who sold their Equity shares before the company's demise were not harmed. Stockholders who still held shares at Equity's collapse lost their investment. Reinsurance companies who bought Equity's fake policies also lost money. The insurance, accounting, and computer businesses had to look carefully at their practices and decide whether or not changes should be made.

Policy holders were absorbed into a Seattle, Washington insurance company, Northern Life, under the supervision of the California State Insurance Department. Northern Life agreed to reinsure the Equity clients' policies, so that policy holders were effectively protected from loss.

REINSURANCE

Equity took advantage of a practice in the insurance business called reinsurance. Reinsurance is a risk-sharing process used by almost all insurance companies. An insurance company is legally responsible for being able to pay out a claim on every policy it carries, should everyone insuring with the company make a claim at the same time. In order to provide for that unlikely event, an insurance company thereby accepts the risk for part of the policy. If a claim is made on it, the reinsuring company is responsible for paying a portion of that claim. In return, the selling company, or "ceding company," pays a portion of the yearly premium for that policy to the reinsuring company.

The reinsurance companies complied with an industry practice of paying very high "first year allowances" to the ceding companies. Equity made a hefty profit when it reinsured phony policies. The first year allowances were designed to help the ceding companies pay their salespeople's commissions, which at the time were very high. First year allowances often amounted to 150-200% of the first year premiums on policies. With fake policies, there was no commission for the ceding company to pay. With the resinsurer's cash from the first year allowance, Equity paid its expenses and bought other companies, thus making itself more valuable and raising the price of its stock.

However, in subsequent years, Equity's phony policies created a self-perpetuating problem for the firm. No one paid the yearly premiums on the phony policies. Equity had to find that money itself, in order to pay the

premiums to the reinsurance companies. To generate the cash, Equity created still more fake policies, reinsured them, and used the money to pay other reinsurers.

When Equity collapsed, the reinsurance companies that had purchased its policies lost money. Suddenly, they received no more annual premiums, although they had made their own investments with the expectation that those premiums would continue to arrive. Many reinsurers had not confirmed the validity of the policies they accepted.

Equity's reinsurance transactions were based on a "gentlemen's agreement" system. The reinsuring company assumed that the ceding company had thoroughly checked into each policy holder before trying to reinsure his or her policy. This was the usual practice in the business.

Today, reinsurance companies still trust that the ceding companies have investigated each policy holder. However, high first year allowances exceeding the amount of the premium are rare. The reinsurers can run checks on policies offered to them, either by contacting the individual policy holders or by confirming medical records through a computerized medical information bureau. Also, part of an insurance company's tri-annual audit is spot checks on the validity of certain policies.

## AUDITS

The fact that Equity Funding Life Insurance Company's independent auditors did not detect or expose the fraud, led to inquiries into standard auditing procedures. Why did the fraud last so long? Were its outside certified public accountants incompetent, were their procedures inadequate, or was the fraud impossible to detect through an audit?

Robert Loeffler, assigned by the U. S. District Court to re-organize Equity Funding Corporation when it filed for bankruptcy, maintained in his report that "there is strong evidence that several of the accountants in charge of these audits were aware of or suspected the fraud and cooperated in its concealment." He continued that if the auditors had done their job, "the fraud would have been caught years ago."*

*Loeffler, Robert, quoted in Michael J. Comer, Corporate Fraud, McGraw-Hill Book Company (UK) Limited, Maidenhead, Berkshire, England: 1977, p. 186-187.

The American Institute of Certified Public Accountants, in the Report of its Special Committee on Equity Funding, concluded that standard auditing practices did not need to be changed as a result of the Equity case. The Committee wrote that any auditor, no matter how competent, works under certain limitations. Auditors cannot detect forgery, for example; nor can they be expected to question documents or information given them by managers of the company being audited. Unrecorded transactions will also go unrecognized by an auditor.

The auditor should, however, observe the internal accounting controls set up by the company. Auditing practices can be altered to compensate if, for example, one person seems to control too many of the company's records, or if employees seem unusually covert in their activities.

When it listed Equity Funding Corporation, the New York Stock Exchange insisted Equity employ a nationally known auditing firm, instead of the smaller, local firm which had been examining the books until then. Equity arranged for its own auditors to merge their firm with another, national firm. The same individuals stayed with Equity's accounts. One of the auditors assigned to examine Equity's books was unable to pass his test as a CPA until after the scandal broke.

## COMPUTERS

Equity stored all of its financial data in computers. The computer was an essential tool in Equity's fraud, but it wasn't the active cause of it.

Fictitious policies were recorded by hand in the company's books, and given to the computer programmers to enter on the computer files. The company's management used the computer's ability to distribute information over a period of time in its records, and to condense it, printing out only final totals instead of individual transactions. Programmers were hired from an outside firm, and they maintained they simply programmed the information given to them.

In the computer files, every life insurance policy was numbered. In the beginning, real policies in the computer were coded on low numbers. Fake policies were coded on very high numbers, and preceded by the initial "Y." But

Equity's real business caught up with its fake computer entries. When the computer automatically sent letters out to all Equity "policy holders," those with the fake addresses were returned . . . by the thousands.

## SECURITIES AND EXCHANGE COMMISSION (SEC)

The Securities and Exchange Commission (SEC) administers the federal securities laws which require corporations to inform the public and investors about companies whose stocks are being publicly traded. The SEC also has a law enforcement program designed to deter securities fraud and to investigate and prosecute companies suspected of fraud.

Equity Funding Corporation did not interest the SEC until very late in the company's career. The day after the SEC heard convincing evidence of the Equity fraud, it went into federal court and obtained an injunction against Equity to halt its false insurance operations. These disclosures led to a withdrawal of all credit by Equity's banks and the filing of a Chapter X bankruptcy petition. The SEC then prosecuted some of the company's executives.

## STATE INSURANCE DEPARTMENT

Insurance companies must comform to the laws of the state in which they are incorporated and doing business. Every state's laws are different, and every state has an insurance commissioner whose primary duty is to protect policy holders. Each state establishes reserve requirements for insurance companies.

Every three years, the state insurance department audits each insurance company in the state. The department issues licenses to insurance companies to do business and also issues licenses to agents and brokers to sell insurance. If a company is in financial difficulty, the state insurance department requests a court order of conservation. The department may then take over the company and either sell it, return it to good financial management, or liquidate it.

Equity Funding Life Insurance Company was incorporated in Illinois. When the Illinois insurance department moved in to take over the Equity company, the California insurance department acted at the same time on Equity's California assets. Equity was ordered to petition for bankruptcy, and was liquidated.

NEW YORK STOCK EXCHANGE

The New York Stock Exchange is a trading association with a limited number of places. Companies must bid for seats and satisfy the Exchange's criteria for membership, which include showing evidence of assets and reliable auditing.

The New York Stock Exchange halted Equity's trading March 27, 1973, after investigating charges that inside information was being passed on predicting Equity's collapse. Stockholders with inside information that Equity was a fraud were selling their stock at high prices before the information was known publicly. Raymond Dirks, the securities analyst whose investigation brought the scandal into the open, testified before the NYSE, but was charged with breaking the Exchange's rules by spreading rumors that affected stock trading, and by sharing his information with selected clientele of his firm.

# WHITE COLLAR CRIME

Student Materials

Author: Phyllis F. Maxey
Business Issues in the Classroom
Constitutional Rights Foundation
Los Angeles, California
Revised, 1983

## WHITE COLLAR CRIME

Embezzlement, fraud, corporate piracy, technological trespassing -- these are the concerns of special law enforcement groups that fight white collar crime. Such crimes fall into a special category because they are quite different from street crimes such as assault, burglary, and murder. Most white collar crimes are committed by people who work in offices who are skilled in accounting, computer science, research, and development. They use their skills to steal money from companies or business partners or, in the case of computer pranksters, to have fun by causing chaos.

In this unit we will examine the All Star Insurance Company case, a white collar crime that actually happened. You will learn what business and government are doing to protect society from this type of crime. To help you understand the complex case of the All Star Insurance Company, you will first read background information on the insurance business, audits, and a government regulatory agency, the Securities and Exchange Commission. Then you will examine the case study in which a member of the All Star Board of Directors learns about the illegal activities of the president of the company.

White collar crime does not occur exclusively in the insurance business. As computers reach into the supermarkets, baseball dugouts, schools, banks, and thousands of other places, the opportunity for such crimes grows.

This unit contains the following activities:

1. READING: Insurance Fact Sheet
2. READING: What Is a Corporation?
3. CASE STUDY: All Star Life Insurance Company
4. VOCABULARY WORKSHEET

# INSURANCE FACT SHEET

1. Why do people buy insurance?

Everyday life has risks -- sickness, auto accidents, death, fire, theft. People buy insurance as protection against the risk of financial loss from these tragedies. An individual makes a small payment each month or perhaps every year into a fund to which others are also making small payments. These payments are called premiums. The fund is used to pay all or part of the financial loss suffered by any member of the group. For example, everyone's house will not burn to the ground, but such a disaster could happen to a few individuals. The money in the fund wil pay those people a fixed amount for their losses.

A policy holder (one buying insurance) is covered for the loss by a set amount of money stated in the insurance policy. The policy, which is a contract between the insurance company and the policy holder, also states the amount of the premium to be paid to the company.

In life insurance, an individual may be protecting his or her family, in the event that the policy holder dies at an unusually young age, leaving a family without adequate financial support. The insurance company that sells the life insurance policy agrees to pay, on the death of the insured, a sum of money as stated in the policy. The insured person names a beneficiary, the individual who is to receive the sum of money paid by the insurance company.

2. How do insurance companies make sure they have enough money to pay all of the claims of policy holders?

Insurance companies employ actuaries, highly trained individuals who calculate risks so that the company knows what to charge for insurance coverage. Actuaries work from mortality tables, statistics which predict the probability of death among large groups of people. Mortality tables are

are based on age only, and they indicate how long people in a certain age group can be expected to live, based on insured people from similar age groups. The amount and number of claims will tell insurance companies how much to charge in premiums.

In addition to the information provided by actuaries, insurance companies hold some funds in reserve. Reserve requirements are established by each state so that a company is protected if a large volume of claims should be made at the same time. Each state has an insurance department that regulates private insurance companies.

Reinsurance is another method of providing enough money to meet policy holders' claims. An insurance company that sells a policy can transfer some of that policy to another company, the reinsurer. The reinsurer agrees to pay to the original insuring company a share of any claim made on that policy. The reinsurer also receives a part of the premium for accepting part of the risk. Thus, the original company which sold the policy has spread some of the risk of paying a claim to the reinsurance company. It's like insurance on insurance.

Insurance companies invest a part of the premiums paid by policy holders. Insurance companies can make a profit from investments and from premiums when that amount is greater than the amount paid out in claims. Companies invest in stocks, bonds, real estate, and mortgage loans. Part of a company's profits may be paid to the company's stockholders.

3. Why do businesses such as insurance companies have audits?

An audit is an examination of a company's financial record by accountants to see if the records are an accurate statement of the company's financial position. An internal auditor is an individual employed by the company to establish internal controls and to review record keeping. Internal controls are part of a system of checks within a company to reduce the chance of employees engaging in fraud. For example, a company might separate the

duties of various employees so that no individual has unrestricted control of a financial transaction from start to finish. Outside auditors, accountants from an independent company who are not employees of the company being audited, examine financial records and make a formal report of their findings.

4. What is fraud?

Fraud takes place when one person intentionally deceives another by misrepresenting what is being sold. For example, insurance policies, stocks, bonds, deeds, and silver certificates are all pieces of paper that represent something of value. In a fraud, a person might sell pieces of paper that are, in fact, worthless, taking cash from an individual who believes he or she is buying something of value.

5. Who protects policy holders and stockholders from insurance fraud?

Many people work to counter fraudulent schemes. Auditors, state insurance commissioners, law enforcement agencies, the Securities and Exchange Commission, and corporations' internal control all work against fraud.

The Securities and Exchange Commission (SEC) administers the federal securities laws which require corporations to inform investors about the companies whose stocks are being publicly traded. The SEC has a law enforcement program to try to combat fraud, by investigating and prosecuting companies. Securities are corporate stock certificates or bonds. Investors buy corporate stocks and bonds, hoping to get a good return on their investments. Stocks are traded on the stock exchanges, such as the New York Stock Exchange and the Pacific Stock Exchange.

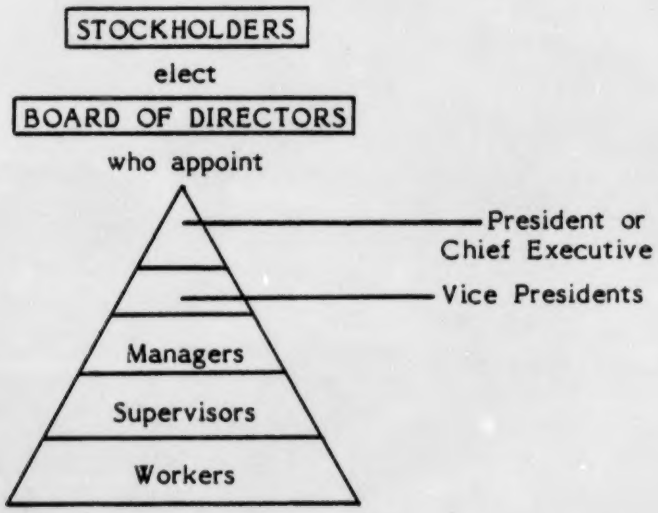
State insurance departments are government regulatory agencies that oversee the operation of insurance companies. Their primary duty is to protect the policy holders. In California, for example, the state insurance department audits every insurance company in the state every three years.

## WHAT IS A CORPORATION?

An insurance company is also a corporation, regulated by state law. It is owned by stockholders who buy shares of stock in the corporation. Stockholders buy stock as an investment; they want to see it increase in value due to wise business decisions and good management. A stockholder can sell his or her stock at any time and receive the market worth. One of the advantages of stocks is that they can be quickly transferred into money. Real estate is another kind of investment, but the owner must wait for the property to be sold. The owners of a corporation have another advantage: limited liability. This means that they are not responsible for paying all the debts should the company fail. They only lose their investment, the worth of the stock they bought. This encourages people to take the risk of buying stock.

The stockholders elect a board of directors. These directors make the policy decisions of the company and review the performance of the chief executive officer, the president of the corporation. Each stockholder has as many votes as shares of stock. The president and senior executives are appointed by the directors. These executives, along with managers and supervisors, operate the company, implementing the policy guidelines established by the directors. Workers carry out the specialized tasks as directed by management to achieve the company's goals.

We might think of the corporation as a pyramid in which those closer to the top have more authority and decision-making power than those at the bottom.



The performance of a corporation's executives is reviewed by many different groups. Stockholders and directors play a major role in judging their actions. But there are other "watchdogs" who protect the stockholders' and consumers' interests. Audits are conducted by accountants inside the corporation as well as outside accountants. Several government agencies supervise corporate actions: the Securities and Exchange Commission (SEC), the Federal Trade Commission (FTC), and the state Insurance Department.

In our case study of the All Star Life Insurance Company, we will see what happens to consumers, employees, and senior executives then this system breaks down. An insurance company has important responsibilities to its policy holders. It must wisely invest the money that comes from the policy holders' premiums. It must be able to cover the claims when a policy holder has a loss. Let's go to the office of the president of All Star Insurance and see what the problems are in this company.

# ALL STAR LIFE INSURANCE COMPANY

The following case study of the All Star Insurance Company is an example of a white collar crime that involves the top executives of an insurance company. The fictional All Star Insurance case is based on the actual Equity Funding Corporation case. In 1973, twenty-one Equity Corporation employees received jail sentences or fines for their participation in the Equity Funding Corporation fraud.

The following meeting in the office of the president of All Star Insurance Company presents the important aspects of the fraud in a dialogue among All Star executives and a member of the All Star Board of Directors.

**********

1. Review the information about insurance and corporations so that you understand the various terms used in this case.
2. Five members of the class should take the roles from the dialogue, and read their roles aloud for the rest of the class.
   Mr./Ms. Solo, President of the All Star Insurance Company
   Mr./Ms. Greenstein, Vice President
   Mr./Ms. Crawford, Junior Executive
   Mr./Ms. Hunkins, Computer Analyst
   Mr./Ms. Thomas, Member of the Board of Directors and Chairman of the Audit Committee
3. Discuss the All Star case using the Discussion Questions that follow the dialogue. What would you do if you were Thomas?
4. Choose a research project based on this lesson that you would like to investigate.

**********

Setting: The office of the president of All Star Life Insurance Company. This is a meeting of the president, a member of the Board of Directors, a senior vice-president, an up-and-coming junior executive, and a computer analyst. (M. refers to Mr. or Ms. as appropriate.)

PRESIDENT SOLO:

I asked all of you to come to my office this morning at the request of Thomas, one of our Directors and chairman of the Audit Committee which met yesterday. M. Crawford, our bright new executive from Hartly Insurance Company, attended that meeting. Crawford, why don't you give us a run-down on the Reinsurance Report that was presented to the Audit Committee?

JUNIOR EXECUTIVE CRAWFORD:

Certainly, M. Solo. Let me say first what a pleasure it is to work for a company with the growth record of All Star Insurance. I'm delighted to be here.

Yesterday, M. Thomas, several other Directors, and I met with the representatives from several of the reinsurance companies with whom we do business. I'm afraid these reinsurers are very concerned about our record keeping. In their review of a sample of our policies they have reinsured, they have discovered some disturbing bits of information:

1. These reinsurance companies hired accountants to review policy holders' files. They found some files missing.
2. When the accountants wrote to All Star Insurance salespeople to check on whether they sold the insurance policies in the missing files, our salespeople often reported that they had NOT sold the policies.
3. Somehow, these accountants have discovered that we are getting many of our mailings to policy holders returned to us marked: RETURN TO SENDER. NOT DELIVERABLE. UNABLE TO FORWARD.

The reinsurers have now asked for more files and computer records.

DIRECTOR THOMAS:

I asked for this meeting because I cannot BELIEVE this Reinsurance Report! How is it that our salepeople deny selling policies that we have on file? What about all of this returned mail? Where are all of these policy holders who bought life insurance from All Star?

PRESIDENT SOLO:

Hunkins, what do you know about all this?

COMPUTER ANALYST HUNKINS:

Well, I have checked the memory banks and I see no problem with the files. We show $4.4 billion in life insurance policies sold to date and that corresponds to the input we have been receiving from the sales department. I don't have records on each individual policy and how much it is worth -- that is in the paper files, not the computer. I have provided the accountants with the printout they requested and additional information that M. Greenstein thought would be helpful.

VICE PRESIDENT GREENSTEIN:

Let's face it. These accountants are just wasting our time with paperwork, checking and rechecking our records. The FACTS are these: our stock has jumped from $6 a share to $60 a share. The corporation is listed on the New York Stock Exchange and Wall Street loves us. This company's market value is almost a billion dollars. So let's get on with it and get these accountants off our backs.

PRESIDENT SOLO:

Well, I am certainly in agreement with that, Greenstein. We can refuse to cooperate any further, and since they can not continue their investigation without our cooperation in supplying records, they'll eventually give up.

DIRECTOR THOMAS:

Wait a minute!! Those guys could also turn us over to the Securities and Exchange Commission and then we'd have a real investigation on our hands. What if the state insurance commissioner gets involved? I think we should find out why these accountants are turning up the disturbing information that Crawford outlined.

PRESIDENT SOLO:

(Turns to Crawford and Hunkins) I have another meeting in a few minutes. I think we should run this by the legal department and see where we stand in dealing with the reinsurers. Thanks for coming. We'll make a decision after we have some additional input.

(Crawford and Hunkins leave the room. The senior vice president, director and the president remain. Solo continues.)

Let me lay out the situation for you, M. Thomas. In order to get some working capital and make this company what it is today, we have sold many of our insurance policies to the reinsurance companies. We have used a technique that we need to keep quiet about.

DIRECTOR THOMAS:

Oh, no! We're all going to jail, right?

PRESIDENT SOLO:

We sold some of our insurance policies to reinsurers. Nothing wrong with that except that they weren't real policies. Since this company is growing so fast and we have to pay our salespeople all the first year insurance premium, we don't have enough cash coming in to pay the other expenses of doing business. In order to get cash, we sell policies to the reinsurers. We found out that the reinsurers don't ever check to see if these are real policy holders . . .

DIRECTOR THOMAS:

WHAT are you talking about?????

PRESIDENT SOLO:

We sold the reinsurers copies of real policies. We used the cash from the reinsurers to make this company grow. So we can't let the accountants from the reinsurance companies continue their probes into our files.

DIRECTOR THOMAS:

You sold reinsurance companies phony life insurance policies? Worthless paper?

PRESIDENT SOLO:

That's right. They bought a part of a policy like they always do. They didn't check to see if there were real people insured under the policies. It never occurred to them that there wouldn't be.

But remember, we aren't hurting the reinsurers. What we are doing is like a temporary loan. We sell them an interest in our policies, and use their money to pay expenses, acquire other companies, and expand All Star. We plan to buy back all those phony policies.

DIRECTOR THOMAS:

But that's FRAUD!

PRESIDENT SOLO:

Look, no one is being hurt. We are now one of the biggest companies in America. Look at how far we've come. As a stockholder of All Star, you know how much your stock is worth now as a result of our growth.

DIRECTOR THOMAS:

Let me go through this again. One of our salespeople sells a $50,000 life insurance policy to John Doe. A reinsurance company buys a part of that policy from All Star. That's all legal, but . . . then you copy the information from that policy, create a phony name and address, and sell the phony policy to a reinsurance company? Who copies the phony policies?

VICE PRESIDENT GREENSTEIN:

We have employed some people who sit all day copying insurance applications, medical records, and policies. They don't complain much, except that the work is boring. They don't know anything about business, and they don't ask questions.

DIRECTOR THOMAS:

So, you take a phony policy, sell it to a reinsurer, and take the money. The reinsurers pay anywhere from 150%-200% of the first year premium, don't they? So with a $1000 premium, you can collect $2000 from the reinsurer?

PRESIDENT SOLO:

That's the system. With that cash, this company is about to become an international corporation with many subsidiaries.

DIRECTOR THOMAS:

Good grief! Aren't the reinsurers suspicious when none of these people insured under the phony policies ever dies?

VICE PRESIDENT GREENSTEIN:

Well, we had to "kill off" some of those people on the phony policies to make the whole thing look legitimate. Phony death certificates are presented to the reinsurer, and then All Star keeps the death benefit paid by the reinsurance company.

DIRECTOR THOMAS:

All Star has sold $2.2 billion dollars of life insurance. How much of that is based on phony policies?

PRESIDENT SOLO:

Approximately $1.3 billion in phony policies.

DIRECTOR THOMAS:

(Becoming increasingly nervous) But what about the annual audits? Don't outside accountants detect any irregularities?

VICE PRESIDENT GREENSTEIN:

We provided our accounting firm with selected computer printouts. Thus, we control the information they get. We also control the input to the computer. We give the computer people the commissions and expenses for the "salespeople" of the phony insurance policies. So the phony accounts look like the real accounts.

DIRECTOR THOMAS:

I can't believe this! You're just going to cover up this enormous fraud! It is a fraud, you know -- selling someone something they think is real when it isn't.

PRESIDENT SOLO:

(Speaking very sternly) Now look here, Thomas. We have been very frank with you, assuming you have a deep interest in the success of this company. Think about how it's going to look with you as chairman of the Audit Committee implicated in all of this. You have your position to think of -- not to mention that you bought our stock when it was worth only $300. Now your same shares are worth $6000. Do you want this company to fold?

DIRECTOR THOMAS:

How many people know about this? I can't believe that none of the employees have spoken up.

PRESIDENT SOLO:

Well, one of them did. He went to the government and to the Stock Exchange, but nobody believed him. Everyone knows that All Star is an outstanding success story and they thought he was just bitter. We fired him, of course.

## DISCUSSION QUESTIONS

1. What would you do if you were Thomas?
2. What happened in this case?
   A. What is fraud?
   B. What is reinsurance?
   C. What is an audit?
3. Which of these individuals or groups behaved in an unethical way?
   A. Senior executives Solo and Greenstein
   B. Junior Executive Crawford
   C. Computer Analyst Hunkins
   D. Director, Chairman of the Audit Committee Thomas
   E. Employees writing phony insurance policies, death certificates, etc.
   F. Accountants
   G. Reinsurance companies
   H. Employee who reported All Star's fraud
   I. Regulatory agencies (SEC, New York Stock Exchange, Insurance Commission)
4. If you were a new employee like Crawford, what could you have done about your suspicions that the company was involved in illegal activities?
5. Who was hurt by All Star's actions? Who benefited?
6. What role do important institutions play in preventing and encouraging white collar crime?
   A. What is the role of the state insurance commission, the Securities and Exchange Commission, and the Stock Exchange in preventing corporate fraud?
   B. What role did "trust" play in this case? Is it possible for humans to interact without trusting each other? Could we create checks and balances on all business transactions and eleminate reliance on trust?
   C. Can anything be done to prevent giant frauds like the All Star case? By the insurance industry? By the accounting profession? By the regulatory agencies?

Essay: Re-read the All Star case. Write an essay stating and explaining your answer to the question, "What would you do if you were Thomas?" What are Thomas's choices? What are the possible consequences of those choices?

Research Projects

The following is a list of topics for further study of various aspects of this lesson plan:

Securities and Exchange Commission
State Department of Insurance
Stock exchanges
Insurance business, reinsurance
Audits, accounting practices
Computer-assisted crime
Fraud
Corporation — structure and responsibilities of Board of Directors, management, and employees
Business ethics — codes of ethics, responsibilities of accountants, insurance companies, etc.
Investment — the role of stockbrokers, securities analysts, investment counselors
Famous cases of white collar crimes

## VOCABULARY WORKSHEET

Place the correct word next to its definition.

| | | |
|---|---|---|
| POLICY HOLDER | REINSURANCE | SECURITIES |
| BENEFICIARY | AUDITOR | STOCK EXCHANGE |
| PREMIUMS | FRAUD | WHITE COLLAR CRIME |

_____ 1. misrepresentation of what is being sold

_____ 2. one who has bought insurance

_____ 3. place where securities are traded

_____ 4. individual who is to receive insurance money on death of the insured

_____ 5. illegal acts committed by office workers, executives, professionals, often hard-to-detect theft or fraud

_____ 6. corporate stocks and bonds

_____ 7. a way of spreading the risk of paying a claim

_____ 8. payment by policy holder for insurance coverage

_____ 9. an accountant who examines a company's financial records

Draw a chart of the structure of a corporation using the following terms: President, Vice President, Stockholders, Managers, Employees, Board of Directors